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No. 94-1768

In the Supreme Court of the United States

OCTOBER TERM, 1994

CAPITOL INDEMNITY CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether, on the facts of this case, petitioner's interest as a surety in an earned progress payment was entitled to the superpriority protection afforded by 26 U.S.C. 6323(c).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-13a) is reported at 41 F.3d 320. The opinion of the district court is reported at 93-2 U.S. Tax Cas. (CCH) ¶ 50,603.

JURISDICTION

The judgment of the court of appeals was entered on November 30, 1994. The petition for rehearing was denied on January 23, 1995 (Pet. App. 14a). The petition for a writ of certiorari was filed on April 24, 1995. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In May 1991, B & H Construction Company contracted with Mt. Vernon Township High School District No. 201 for asbestos removal and other work to be completed by August 9, 1991, for a total price of $248,340. The contract price was due in monthly progress payments upon certification by the project architect that the appropriate share of the work had been completed satisfactorily and that the subcontractors and suppliers had been paid. The contract provided for a ten percent "retainage" to be withheld from each progress payment until the satisfactory completion of the project. The contract further provided that neither the school district nor the architect had any contractual obligation to pay subcontractors for any work they might perform at the contractor's direction (Pet. App. 2a).

As required by the contract, the contractor procured payment and performance bonds on May 31, 1991. The bonds were issued by petitioner as surety. The contractor also had a preexisting general indemnity agreement with petitioner under which the contractor assigned to petitioner all of its rights under its construction contracts. That assignment was subject to defeasance upon the satisfactory completion of the contract work (Pet. App. 2a).

Work on the project began on June 4, 1991, but the contractor immediately fell behind schedule. Even after the school district modified the contract to reduce the work to be done, the contractor still failed to meet the modified deadlines. The August 9, 1991, completion date arrived with no end to the job in sight. The subcontractors began complaining about delayed or inadequate payments but did not file a

notice of lien pursuant to Section 23 of the Illinois Mechanics Lien Act, 770 Ill. Comp. Stat. 60/0.01 (1993) *et seq.* (Pet. App. 3a).

By early September 1991, the contractor had completed work under the contract valued at $143,993. The contractor submitted a progress payment application which, minus previously paid sums and retainage, totaled $102,341. That application was formally certified for payment on September 17, 1991 (Pet. App. 4a).

Meanwhile, in July 1991, the Internal Revenue Service had notified the contractor of an unpaid federal tax assessment in the amount of $124,448 and filed notices of lien with respect to that assessment. When the contractor failed to pay the assessment, the Service issued a notice of levy to the school district on September 12, 1991 (Pet. App. 3a). Upon receipt of the notice, the school district decided not to issue the progress payment to either the contractor or the Internal Revenue Service. Instead, on October 7, 1991, the school district declared the contractor in default and, on October 9, 1991, demanded that petitioner perform on its bonds and complete the project. Petitioner completed the project and paid the subcontractors. In May 1992, petitioner received the withheld progress payment of $102,341 from the school district, along with the remainder of the contract funds (*id.* at 4a).

2. Petitioner brought this action alleging that the tax levy was wrongful because the contractor had no interest in the progress payment. The government counterclaimed that the progress payment was impressed with its lien and also filed a third-party counterclaim against the school district for failure to honor the levy (Pet. App. 4a).

On a motion for summary judgment, the district court held against the government on both claims. The court held that the Illinois Mechanics' Lien Act entitled the subcontractors to the portion of the progress payment that represented the work that they had completed ($85,921) and that this amount was correctly paid to petitioner on the subcontractors' behalf. The court further held that the balance of the payment ($16,420) belonged to petitioner, rather than the contractor, because the general indemnity agreement effected an assignment of the contractor's rights to petitioner (Pet. App. 4a). The court concluded that the contractor "had no property right in the progress payment, and that the government thus had nothing to levy against" (*id.* at 5a).

3. The court of appeals reversed (Pet. App. 1a-13a). The court rejected the district court's conclusion that the contractor had no property interest in the progress payment to which the federal tax lien could attach.

The court held first that the progress payment was not the property of the subcontractors (to which petitioner, as surety, would have succeeded under the theory of equitable subrogation) but was instead the property of the general contractor. The court reached that conclusion because (i) the contract between the school district and the contractor did not give the subcontractors any rights in the progress payment or create a trust for their benefit, (ii) the subcontractors had failed to comply with the applicable state law providing them recourse outside the contract (Illinois Mechanics Lien Act, 770 Ill. Comp. Stat. 60/23) (1993) and (iii) Illinois law recognized a subcontractors' equitable rights in con-

struction contracts only for retainages and not for progress payments (Pet. App. 5a-8a).

Relying on *United States* v. *R.F. Ball Construction Co.*, 355 U.S. 587 (1958), the court of appeals further rejected the district court's determination that the general indemnity agreement transferred all rights in the progress payment from the contractor to petitioner. The court held that the assignment created by that agreement gave petitioner only an unperfected security interest in the contract proceeds until the contractor defaulted and petitioner was called upon to perform on its bonds. The court noted that default did not occur until the school board declared it *after* the notice of federal tax lien for the contractor's unpaid taxes had been filed (Pet. App. 9a-11a).

The court of appeals concluded that petitioner's right of equitable subrogation—which entitled petitioner to "step into the shoes" of the contractor and subcontractors—did not take effect until petitioner undertook substitute performance under the surety bonds. The court stated (Pet. App. 11a):

> By the time [petitioner] could assert its right of subrogation, no claims remained for the surety to be subrogated to: the subcontractors had lost their potential interest by failing to file notices of lien, B & H had had its property subjected to the IRS lien, and the [school] [d]istrict had neglected to take the opportunity to declare B & H in default and to withhold the progress payment on that basis.

Having determined that the contractor had a property interest in the progress payment to which the federal tax lien attached, the court of appeals con-

cluded that the federal tax lien primed petitioner's unperfected security interest in the contract rights. Because the surety's lien was not perfected until after the notice of federal tax lien had been filed, the federal lien prevailed under the principle that the "first in time is first in right" (Pet. App. 11a).

The court then rejected the further claim that petitioner was entitled to prevail under the "superpriority" exception of 26 U.S.C. 6323(c). The court noted that, for the "superpriority" provision to apply, petitioner's surety's lien had to be protected under local law, as of the time of tax lien filing, against a judgment lien arising out of an unsecured obligation (Pet. App. 12a, citing 26 U.S.C. 6323(c)). Petitioner's surety claim did not qualify under this provision because petitioner had failed to file a financing statement with the appropriate state office and was therefore not protected against other unsecured creditors under the applicable local law (Pet. App. 11a-12a).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court, any other federal appellate court or the highest court of Illinois. Further review of the question of Illinois law presented by the petition is not warranted.

1. The court of appeals correctly concluded that, under Illinois law, the surety did not have a valid claim of subrogation in the funds that were subject to the federal lien.

a. Petitioner had no right of subrogation through the subcontractors because the subcontractors themselves had no contract right to any share of the progress payment (Pet. App. 7a). The court of appeals correctly determined that Illinois law recognizes a

subcontractor's equitable rights in a construction contract only for retainage payments, not for progress payments. See *Avco Delta Corp. Canada Ltd.* v. *United States*, 484 F.2d 692 (7th Cir. 1973), cert. denied, 415 U.S. 931 (1974). In addition, the subcontractors had not complied with the Illinois Mechanics Lien Act and therefore had no statutory lien claim directly against the progress payment (Pet. App. 8a). See *Board of Education of School Dist. No. 108* v. *Collom*, 222 N.E.2d 804 (Ill. App. Ct. 1966).

b. The court of appeals also correctly found that petitioner had no right of subrogation through the school district. The school district did not declare a default until after it certified the progress payment; it thereby forfeited its claim to the fund under Illinois law. See *Northwest Water Commission* v. *Carlo* V. *Santucci, Inc.*, 516 N.E.2d 287 (Ill. App. Ct. 1987), appeal denied, 522 N.E.2d 1247 (Ill. 1988).

c. The court of appeals also correctly found that the surety had no right of subrogation through the contractor itself. The contractor's interest in the progress payment was unquestionably subject to the federal tax lien under 26 U.S.C. 6321 (Pet. App. 11a).

2. The court of appeals then turned to the separate question whether 26 U.S.C. 6323(c) affords petitioner's claim as surety a "superpriority" against the federal tax lien. That statute permits certain types of lien claims to prevail against an earlier-filed tax lien if the later lien would be protected, under state law, against "a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation." 26 U.S.C. 6323(c)(1)(B). The court of appeals correctly determined that the surety's claim in this case—based upon the ostensible assignment provision of the general indemnity agreement—was *not* protected

against a judgment lien under state law. As the court noted, the surety had failed to perfect its claim against unsecured creditors by filing a financing statement in accordance with Illinois law (Pet. App. 12a, citing 810 Ill. Comp. Stat. 5/9-302 (1993)).

Petitioner cites several cases for the proposition that a surety is not required to file a financing statement to perfect its security interest in contract proceeds (Pet. 2-3, 12-14). All but one of those cases, however, involve the law of different States; they therefore do not evidence a conflict on the question of Illinois law decided by the court of appeals in this case.

The one case cited by petitioner that applies Illinois law (*Home Indemnity Co.* v. *United States*, 433 F.2d 764 (Ct. Cl. 1970)) does not conflict with the decision in this case. The *Home Indemnity* case concerned the right of a surety to funds withheld from a contractor pending completion of the project. The court held that the surety had a claim of equitable subrogation to the funds due on completion of the contract (*id.* at 765). Because the common law right of subrogation is not a "security interest" to which the requirements of the Uniform Commercial Code apply, however, the *Home Indemnity* court did not address or decide the question decided in this case. See *ibid.* There is thus no conflict among the circuits on the question of Illinois law decided by the court of appeals in this case. See also *Ruhlin* v. *New York Life Ins. Co.*, 304 U.S. 202, 206 (1938).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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